

MOODY'S ASSIGNS Aa3 RATING TO STATE OF CALIFORNIA GENERAL OBLIGATION BONDS

NEW YORK, Dec 8, 1998 -- Moody's has assigned a rating of Aa3 to the general obligation bonds of the State of California. The rating reflects the state's deep and diverse economic base, its improved credit condition, including the rebuilding of cash and budget reserves, and long-term structural budget condition, even under assumptions of slowing economic growth. The credit outlook is stable.

The state's Aa3 rating is the product of its robust economy, offset by a financial condition that shows dramatic improvement, but still lags that of most states. The California economy has fully recovered from the recession of the early 1990's, and continues to outpace the United States in terms of employment and personal income growth. Diversification has positioned it for further expansion, although at a slower pace than has been realized over the last several years. General fund balance sheet deficits accumulated during the recession have been substantially reversed and liquidity has been restored. New five-year financial projections based on reasonable expenditure and revenue assumptions indicate that the state has the capacity to maintain long-term budget balance, even if economic growth slows. Budget reserves are funded at levels that, while still low by national standards, would preserve liquidity in a mild economic downturn. Its debt position is moderate though slowly increasing as the state addresses its infrastructure needs.

At Aa3, California's rating is lower than that of most of the country's large industrialized states, including Illinois, Texas, and Florida (each rated Aa2), Michigan, New Jersey and Ohio (all Aa1), but is higher than New York State's A2 rating. California shares the Aa3 rating with Pennsylvania, Massachusetts and Connecticut. California's ranking among the states reflects its still relatively weak, though improved, balance sheet condition, and its above average exposure to international economic uncertainty. In addition, we expect that California would move more slowly than most states to stem financial deterioration in the event of economic recession due to its inflexible budget structure and complex political environment.

The Aa3 general obligation rating is based on the following credit factors:

CREDIT STRENGTHS

- Economic recovery is now well-established and broad based, and absent a national recession, continued, though slowing, job and income growth is expected.
- Financial performance benefits from economic recovery's positive impact on economically sensitive income and sales taxes.
- Long term spending pressures from caseload driven demand in social services, schools, and prisons have eased compared to earlier expectations and can be funded with available revenues.
- Liquidity from cash resources outside the General Fund shows strong improvement.
- Contingent reserve position significantly improved, offering moderate protection against economic uncertainties.

CREDIT WEAKNESSES

- Financial flexibility remains limited due to education expenditures mandated by Proposition 98.
- Lack of formalized mid-year budget correction capabilities leaves the state exposed in periods of revenue under-performance.
- Future capital needs could weaken debt position if debt affordability recommendations are not adhered to.
- Economically-sensitive tax structure produces revenue volatility.
- The state faces above-average exposure to international economic conditions, particularly in Asia.

WEAKENING TRADE WILL LOWER REVENUE ESTIMATES IN FY 2000

As a result of the ongoing Asian economic crisis and a slowdown in economic growth in Mexico, total state manufactured commodity exports have declined by 3.3% through the first three quarters of 1998 over comparable 1997 totals. While the state anticipated a decline in trade to the Pacific Rim, its out-year revenue estimates did not assume as dramatic a slowdown in growth in exports to Mexico as has been experienced to date. Growth in exports to Mexico, while still positive, has been insufficient to make up for the continued decline in Asian exports.

Despite the weakening trade results, the state's economy has continued to outperform the nation in terms of employment and wage growth, and unemployment dropped to 5.9% in October, minimizing risks regarding revenue targets for the current fiscal year. However, it is anticipated the lower trade figures will result in reduced revenue collections in fiscal 2000, a risk highlighted earlier by the Legislative Analyst's Office.

FY 2000 BUDGET PREPARATIONS PROCEEDING

Transition planning by representatives of newly-elected Governor Gray Davis is underway. As constitutionally required, the Governor will submit his fiscal 2000 budget recommendations to the legislature no later than January 10, 1999. Each state agency has submitted a formal budget request to the Department of Finance, and such submissions have been reviewed as part of this effort. Moody's does not anticipate the January budget submission will include any major budgetary policy recommendations, but these are more likely to emerge as part of the May Revision process when fiscal 1999 revenue performance is largely known.

OUTLOOK:

The rating outlook for the state is stable. The economy is projected to continue to grow, but at a slower rate, as a result of above-average exposure to international economic conditions and capacity constraints in the high technology sector. Although some new incremental revenue weakening may be emerging, it is within the range of uncertainty identified earlier in the year. The fiscal plans of the new administration are not yet apparent but will begin to emerge in the budget process between January and June.

Still, the state's budget is expected to remain balanced even as growth slows, as easing spending pressures have produced a better structural balance between ongoing revenues and expenditures. General Fund reserves may decline in fiscal 2000 if projected revenue shortfalls are not addressed through offsetting expense reductions. Given the scale of capital needs, the debt burden is likely to grow, but a new annual debt affordability process may constrain that growth somewhat.

DEBT AFFECTED

ISSUE	RATING
General Obligation Bonds	Aa3
Sale Amount \$600,000,000.00	
Expected Sale Date 12/09/98	
Rating Description General Obligation Bonds	

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